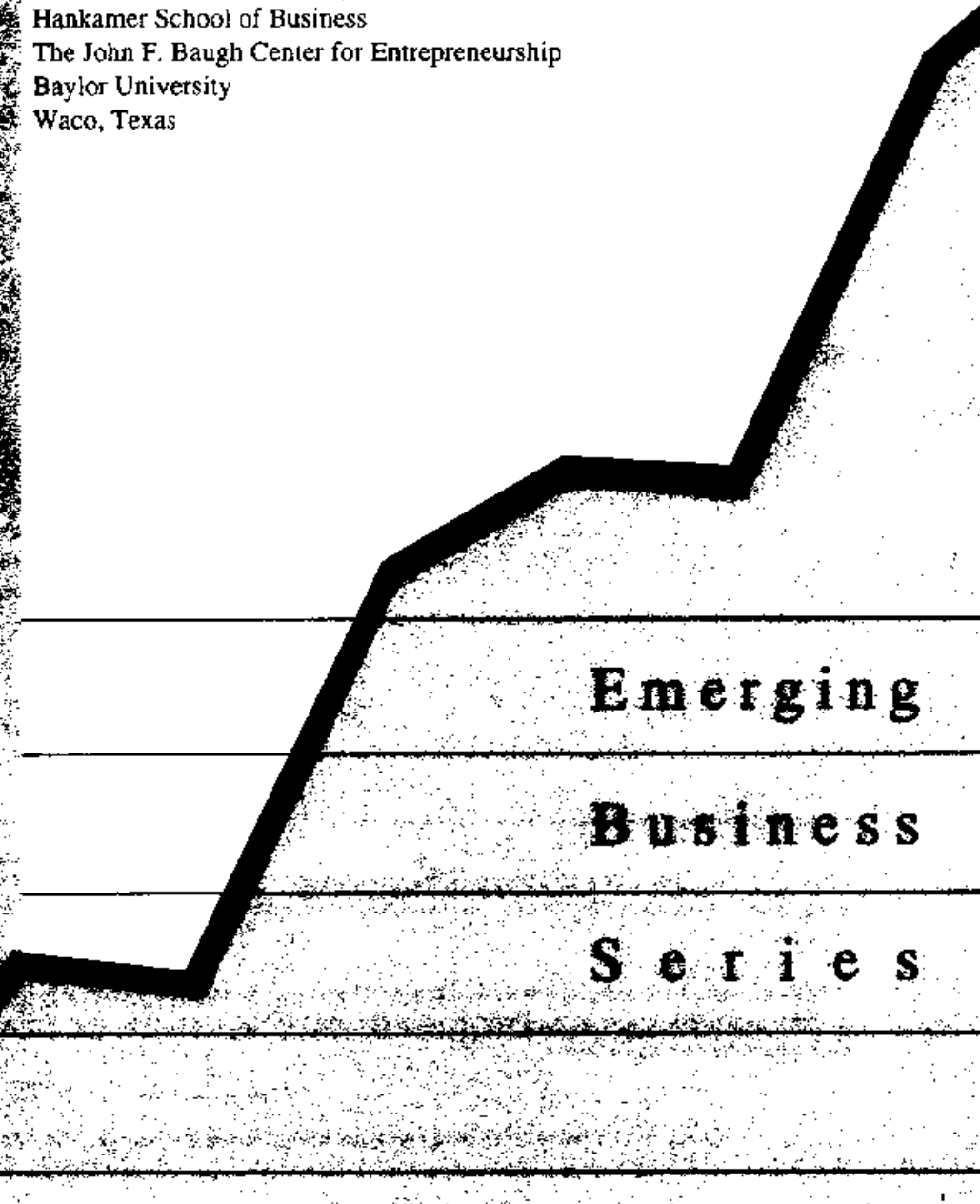


# Transferring Management in the Family-Owned Business

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Emerging  
Business  
Series

*Building America's Future*

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## INTRODUCTION

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The family business is a vital force in the American economy. About 90 percent of all U.S. businesses are family owned or controlled. They range in size from the traditional small business to a third of the *Fortune 500* firms. It is estimated that family businesses generate about half of the country's Gross National Product and half of the total wages paid.

The American economy depends heavily on the continuity and success of the family business. It is unfortunate, even alarming, that such a vital force has such a poor survival rate. Less than one third of family businesses survive the transition from first to second generation ownership. Of those that do, about half do not survive the transition from second to third generation ownership.

At any given time, 40 percent of U.S. businesses are facing the transfer of ownership issue. Founders are trying to decide what to do with their businesses; however, the options are few. The following is a list of options to consider:

- Close the doors.
- Sell to an outsider or employee.
- Retain ownership but hire outside management.
- Retain family ownership and management control.

To be one of the few family businesses that survive transfer of ownership requires a good understanding of your business and your family. There are four basic reasons why family firms fail to transfer the business from generation to generation successfully:

- Lack of viability of the business.
- Lack of planning.
- Little desire on the owner's part to transfer the firm.
- Reluctance of offspring to join the firm.

These factors, alone or in combination, make transferring a family business difficult, if not impossible. The primary cause for failure, however, is the lack of planning. With the right plans in place, the business, in most cases, will remain healthy. There are four plans that make up the transition process. By implementing these plans, you will virtually ensure the successful transfer of your business within the family hierarchy.

A brief explanation of each plan follows.

- A *strategic plan* for the business will allow each generation an opportunity to chart a course for the firm. Setting business goals as a family will ensure that everyone has a clear picture of the company's future.
- The *family strategic plan* is needed to maintain a healthy, viable business. This plan establishes policies for the family's role in the business. For example, it may include an entry and exit policy that outlines the criteria for working in the business. It should include the creed or mission statement that spells out your family's values and basic policies for the business. The family strategic plan will address other issues that are important to your family. By implementing this plan, you may avoid later conflicts about compensation, sibling rivalry, ownership and management control.
- A *succession plan* will ease the founding or current generation's concerns about transferring the firm. It outlines how succession will occur and how to know when the successor is ready. Many founders do not want to let go of the company because they are afraid the successors are not prepared, or they are afraid to be without a job. Often, heirs sense this reluctance and plan an alternative career. If, however, the heirs see a plan in place that outlines the succession process, they may be more apt to continue in the family business.
- An *estate plan* is critical for the family and the business. Without it, you will pay higher estate taxes than necessary. Taking the time to develop an estate plan ensures that your estate goes primarily to your heirs rather than to taxes.

For business owners who do little planning, the idea of preparing four plans may seem overwhelming. Although it is not easy, the commitment made by all family members during the planning process is the key ingredient for business continuity and success. The first rule for successfully operating and transferring the family firm is: "Share information with all family members, active and nonactive." By doing this, you will eliminate problems that arise when decisions are made and implemented without the knowledge and counsel of all family members.

This publication will help you plan for a successful transfer of ownership and avoid many of the problems family businesses face when transfer of ownership occurs. The appendixes include aids to help you implement the process.

## UNDERSTANDING THE FAMILY BUSINESS

This section will explore the nature of the family business as a dual operating system, and will identify issues of greatest concern to family business owners, as identified by family business owners across the United States. As you review these issues, you will see that, although you and your family are unique, the challenges you face are not, because almost every family business shares the same problems.

Also, perspectives of the individuals involved in a family business will be presented. We tend to confuse personality with perspective—understanding the viewpoints of the different actors involved in the family business (active and nonactive) can help alleviate conflicts that may arise.

After reading this section, you and your family should complete the *Family Business Assessment Inventory* in Appendix A.

### What Is a Family Business?

Defined simply, a family business is any business in which a majority of the ownership or control lies within a family, and in which two or more family members are directly involved. It is also a complex, dual system consisting of the family and the business; family members involved in the business are part of a task system (the business) and part of a family system. As you can see in Figure 1, these two systems overlap. This is where conflict may occur because each system has its own rules, roles and requirements. For example, the family system is an emotional one, stressing relationships and rewarding loyalty with love and with care. Entry into this system is by birth, and membership is permanent. The role you have in the family—husband/father, wife/mother, child/brother/sister—carries with it certain responsibilities and expectations. In addition, families have their own style of communicating and resolving

conflicts, which they have spent years perfecting. These styles may be good for family situations but may not be the best ways to resolve business conflicts.

Conversely, the business system is unemotional and contractually based. Entry is based on experience, expertise and potential. Membership is contingent upon performance, and performance is rewarded materially. Like the family system, roles in the business, such as president, manager, employee and stockholder/owner, carry specific responsibilities and expectations. And like the home environment, businesses have their own communication, conflict resolution and decision-making styles.

Conflicts arise when roles assumed in one system intrude on roles in the other, when communication patterns used in one system are used in the other or when there are conflicts of interest between the two systems. For example, a conflict may arise between parent and child, between siblings or between a husband and wife when roles assumed in the business system carry over to the family system. The boss and employee roles a husband and wife might assume at work most likely will not be appropriate as at-home roles. Alternatively, a role assumed in the family may not work well in the business. For instance, offspring who are the “peace makers” at home may find themselves mediating management conflicts between family members whether or not they have the desire or qualifications to do so.

A special case of role carryover may occur when an individual is continually cast in a particular role. This happens primarily to children. Everyone grows up with a label: the “good one,” the “black sheep,” the “smart one.” While a person may outgrow a label, the family often perceives that person as still carrying the attribute. This perception may affect the way that person operates in the business.

Family communication patterns don’t always affect the business, but when they do it can be very embarrassing. Often you say things to family members in a way you would never speak to other employees or managers. This problem is compounded when your communication is misread by the family member. Often parents are surprised by a son’s or daughter’s negative reaction to a business directive or performance evaluation. This reaction is probably because the individual perceived the instructions or evaluation as orders or criticism from Dad or Mom, not from the boss.

System overlap is apparent when conflicts of interest arise between the family and the business. Some families

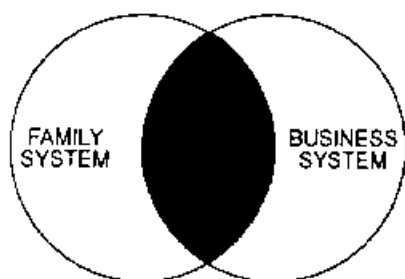


Figure 1

put personal concerns before business concerns instead of trying to achieve a balance between the two. It is important to understand that the family's strong emotional attachments and overriding sense of loyalty to each other create unique management situations. For example, solving a family problem, such as giving an unemployable or incompetent relative a position in the firm, ignores the company's personnel needs but meets the needs of family loyalty.

Another example of conflict of interest occurs when business owners feel that giving children equal salaries is fair. Siblings who have more responsibility but receive the same pay as those with less responsibility usually resent it. In cases of sibling rivalry, it isn't unusual for one sibling to withhold information from another or try to engage in power plays, i.e., behaviors that can be detrimental to the firm.

Much of this behavior can be eliminated or managed by devising policies that meet the needs of both the family and the business. Developing these policies is part of the family strategic planning process. Before discussing them, you should make sure you have identified all the issues that need to be addressed.

### **Issues in the Family Business**

The list below contains the issues that most family businesses face:

- **Participation**—who can participate in the family business and under what circumstances.
- **Leadership and ownership**—how to prepare the next generation to assume responsibility for the business.
- **Letting go**—how to help the entrepreneur let go of the family business.
- **Liquidity and estate taxes.**
- **Attracting and retaining nonfamily executives.**
- **Compensation of family members**—equality versus merit.
- **Successors**—who chooses and how to choose among multiple successors.
- **Strengthening family harmony.**

All of these issues and the others you include in the Family Business Assessment Inventory can potentially cause business conflict and family stress. But there are three steps you can take to manage conflict and stress in a family business:

- Identify issues that may cause conflict and stress.
- Discuss these issues with the family.
- Devise a policy to address them.

A discussion of policy making, as well as establishing a forum conducive to it, will be addressed later, in the section "Family Retreat."

### **Who Are the Actors?**

The next consideration in understanding the family business is to understand the perspectives of those involved. Without this understanding, managing a family business will be difficult.

The actors in the family business can be divided into two groups: (1) family members and (2) nonfamily members. Each group has its own perspective and set of concerns and is capable of exerting pressures within the family and the firm.

#### **Family Members**

##### *Neither an Employee nor an Owner*

Children and in-laws are usually in this group. Although they may not be part of the business operations, they can exert pressure within the family that affects the business. For example, children may resent the time a parent spends in the business. This creates a problem because parents usually develop guilt feelings as a result of their neglect and the resentment expressed by the children. In-laws, on the other hand, are viewed either as outsiders and intruders or as allies and therefore are usually ignored or misunderstood. For example, a daughter-in-law is usually expected to support her husband's efforts in the business without a clear understanding of family or business dynamics. She may contribute to family problems or find herself in the middle of a family struggle. The son-in-law faces similar, if not worse, problems. He may be placed in a competitive situation with his wife's brothers. If he isn't involved in the family business, he can still exert pressure on the business in his role as his wife's confidant.

##### *An Employee but not an Owner*

This family member works in the business but does not have an ownership position. For this individual, conflict may arise for a number of reasons. For example, if he or she compares himself or herself to the family member who has an ownership position but is not an employee, a sense of inequity may result. The member may voice his or her resentment: "I'm doing all the work, and they just sit back and get all the profits." Or resentment may occur

when decisions are made by owners alone. Here, he or she may feel: "I'm working here every day. I know how decisions are going to affect the company. Why didn't they ask me?" Family members employed in or associated with a family business generally expect to be treated differently from nonfamily employees.

#### *An Employee and an Owner*

This individual may have the most difficult position. He or she must effectively handle all the actors in both systems. As an owner, he or she is responsible for the well-being and continuance of the business, as well as the daily business operations. He or she must deal with the concerns of both family and nonfamily employees. Often, the founder, as the sole owner and chief executive, falls in this category.

#### *Not an Employee but an Owner*

This group usually consists of siblings and retired relatives. Their major concern usually is the income provided by the business; thus, anything that threatens their security may cause conflict. For example, if the managing owners want to pursue a growth strategy that will consume cash and has an element of risk, they may face resistance from retired relatives who are concerned primarily about dividend payments.

#### **Nonfamily Members**

##### *An Employee but not an Owner*

This group deals with the issues of nepotism and coalition building and the effects of family conflicts on daily

operations. Owners' concerns for nonowner employees usually involve recruiting and motivating nonfamily employees and nonfamily owner-managers who will have little or no opportunity for advancement, accepting children of nonfamily managers into the business and minimizing political moves that support family members over nonowner employees.

#### *An Employee and an Owner*

With the emergence of stock-option plans, this group has become more important. Employees may become owners during a succession. In companies where a successor has been chosen, partial ownership of the company by its employees can foster cooperation with the new management because the employees will personally share the benefits and responsibilities of the company. In cases where there is no successor, selling the company to the employees who have helped build it makes good business sense. Employees who own the company will want to be treated like owners, which may be difficult for family members to understand and accept. A thorough understanding of the behavioral consequences of an employee stock ownership program (ESOP) should be grasped before a family implements such a program. Understanding the perspective of the individuals around you, both family and nonfamily, will make communicating and decision making easier.

## **BALANCING FAMILY AND BUSINESS GOALS**

When conflict occurs in the family business, it can be traced to a disparity in the goals of the individuals, the family or the business. Perhaps a family member works in the business out of economic necessity, not because he or she wants to. Or perhaps the potential successor has plans for the business that differ from current management plans—different generations usually have different goals. Whatever the cause, the conflict must be addressed and resolved to avoid and prevent more serious problems later.

One way to define and align family and business goals is through *business and family strategic planning*. In these plans, you will create a mission statement for the business and for the family that allows each element to complement the other. Once you have completed this

task, set goals for the family business that will allow the family and business to prosper. Next, develop a strategy to accomplish these goals and, finally, formulate policies and procedures that control the family's involvement in the business. Appendix B, the Strategic Plan Checklist, can help you review the steps in strategic planning.

### ***Business Strategic Planning***

Strategic planning for family-owned businesses requires that you integrate family issues, such as:

1. What are the long-term personal and professional goals of family members?



2. What is the family mission? Why are you committed to establishing and operating the business?
3. How do you envision the firm in the future?
4. Will family members be active in management or will they be passive members?
5. How will issues such as compensation, benefits and performance evaluation be handled?

The answers to these questions will affect the business strategy and should be resolved before strategic planning begins.

Strategic planning involves analyzing the business in its environment and devising a process for guiding its development and success in the future. This process involves assessing the internal operations and the current external environment (i.e., economic, technological, social and political forces) that affect the business. To begin this process, identify internal strengths and weaknesses that may constrain or support a strategy. Components of this assessment include (1) the organizational structure, (2) the culture and (3) the resources. Make a list of the opportunities available (growth, new markets, a change in regulations) and the threats (increased competition, shortage of raw materials, price cutting) to your business. This should give you some insight into the current situation and provide a strategic direction.

Next, list the objectives of you and your family, identifying personal needs and risk orientation. Many of these objectives and goals will be addressed in your family strategic plan. Also, you will find that your personal objectives will affect the strategy you choose. For example, if there is a great opportunity for growth in your market but you have a low risk orientation and a high personal need for security, you probably should not pursue high growth. It would be not only risky but also expensive. Growth consumes cash, and cash must be generated internally or financed externally. Your personal objectives should mesh with your strategy.

Once you have identified opportunities in the industry, assessed the strengths and weaknesses of the firm and listed your personal objectives, you can proceed with the strategic plan. This will involve

- developing a mission statement,
- setting objectives,
- developing strategies to meet objectives, and
- developing action steps to implement the strategy.

## Mission Statement

The mission statement answers the question "What business are you in?" It defines your customers and explains why you are in business. The mission statement embodies the heart of the business and gives direction to every facet of the business. Effective mission statements

- include specifications that allow measurement,
- establish the individuality of the firm,
- define the business in which the firm wants to be involved,
- are relevant to all with a stake in the firm, and
- are exciting and inspiring.

## Objectives

You should set reasonable objectives for the firm, based on the mission statement, to ensure accomplishment of the firm's mission. Objectives should be clearly stated, realistic, measurable, time specific and challenging. Objectives can be created for

- revenue growth,
- earnings growth,
- sales and market share growth,
- new plants or stores, and
- product/service quality or corporate image.

## Strategies

Strategies are determined by your answer to the earlier question: "What will the firm be like in the future?" Your strategic options include the following:

- *Stability*—success is derived from little change (rare).
- *Profit strategy*—sacrifice future growth for profits today.
- *Growth strategy*—growth may be achieved through vertical integration (expansion from within), horizontal integration (buy a competitor), diversification, merger or retrenchment (turnaround or divestment).

## Action Steps

Once the strategy is selected, action steps should be specified that will guide the firm's daily activities. An example of an action step is creating a budget to project the costs of a strategy. This process also is known as *tactical planning*. The steps in tactical planning should be

practical and easy to implement and account for; their purpose is to convert goals into manageable, realistic steps that can be individually implemented.

**Family Strategic Planning**

The entire family should develop a mission statement or creed that defines why it is committed to the business. By sharing priorities, strengths and weaknesses, and the contribution each member can make to the business, the family will begin to create a unified vision of the firm. This vision will include personal goals and career objectives.

An important issue to consider is how to set priorities for the family and the business, i.e., decide which will come first, the family or the business. How you answer this question will influence your planning. Some family members will opt for the business first, reasoning that, without a business, there will be no financial security for the family. Others will opt for the family first, reasoning that no business is worth the loss of family harmony. A third alternative is to serve both family and business—perhaps not equally, but as fairly as possible. Under this alternative, all decisions are made to satisfy both family and business objectives. For example, a family may have a policy that any family member may join the business, but he or she must meet the requirements of the job. You may find this is the best alternative because it forces a commitment to both the family and the business.

**The Family Retreat**

Trying to plan a business strategy during normal office hours is almost impossible. Plan a family business retreat to discuss the goals of the individual family members and the goals of the business. The first retreat should focus on reviewing the firm's history, defining family and business values and missions, creating a statement about the future of the business and reviewing areas that need more attention.

The purpose of the retreat is to provide a forum for introspection, problem solving and policy making. For some participants this will be their first opportunity to talk about their concerns in a nonconfrontational atmosphere. It is also a time to celebrate the family and enhance its inner strength.

A retreat usually lasts two days and is held far enough away so you won't be disturbed or tempted to go to the office. Every member of the family, including in-laws, should be invited. Begin planning your retreat about six weeks in advance.

Once you have picked a time and place, establish a tentative agenda. The agenda in Table 1 is typical.

Your actual agenda will be tailored to meet the unique needs of your family and business. Usually families will identify some of the following issues for discussion at their first retreat:

- A family creed or mission statement.
- Management succession.
- Estate planning.
- Strategic business planning.
- The reward system.
- Performance evaluation.
- Communication within the family.
- Preparing adult children to enter the business.
- Transition timing.
- Exit and entry policies.

Table 1 – Agenda for Family Retreat		
<b>Day 1</b>		
8:00–10:00		Review family business history and current operations.
10:00–12:00		Discuss individual career goals and assess individual roles in the business.
1:00–3:00		Discuss future plans of the company and how family members fit in.
3:30–5:00		Prepare written statements of the family and business mission statements and goals.
<b>Day 2</b>		
8:00–10:00		Discuss areas in which policies need to be drafted (e.g., entry, exit, compensation).
10:00–11:30		Prepare a preliminary draft of policies.
1:00–3:00		Discuss areas in which better communications are needed. What methods are needed to keep everyone (including nonoperating family members) informed?
3:30–5:00		Review retreat and plan for next meeting.

A series of questions that can be used to identify topics for discussion is included in Appendix C.

You may consider using a retreat facilitator, a professional experienced in helping family-owned businesses. The facilitator helps identify issues for discussion before the retreat and keeps the atmosphere nonconfrontational during the retreat. The facilitator does not solve the family's problems but guides the family in doing so.

The retreat is the beginning of a process. When a consensus is reached by the participants, policies should be set, courses of action planned and responsibility for

implementation assigned. When agreement cannot be reached, further discussions should be planned, possibly with the continued assistance of the facilitator.

One important outcome of the retreat should be plans for periodic family meetings and retreats in the future, so the dialogue will continue. Open communications will enable the family to come to grips with problems and issues while they are fairly easy to solve. Once family members have reached a consensus on the continuity of the firm and their roles in it, you can begin planning for succession.

## CHOOSING A SUCCESSOR

Succession is the transferring of leadership to the next generation. It is a process rather than an event. While there is a time frame within which the transition will occur, the actual amount of time taken for the process is arbitrary. It will depend on you, your family and the type of business you are in. This is a difficult process for most family businesses. The failure to face and plan for succession has been termed the "succession conspiracy" by Ivan Landsberg (1988). He cites a number of forces that act against succession planning:

- *Founder*

- Fear of death.
- Reluctance to let go of power and control.
- Personal loss of identity.
- Fear of losing work activity.
- Feelings of jealousy and rivalry toward successor.

- *Family*

- Founder's spouse's reluctance to let go of role in firm.
- Norms against discussing family's future beyond lifetime of parents.
- Norms against "favoring" siblings.
- Fear of parental death.

- *Employees*

- Reluctance to let go of personal relationship with founder.
- Fears of differentiating among key managers.

- Reluctance to establish formal controls.
- Fear of change

- *Environmental*

- Founder's colleagues and friends continue to work.
- Dependence of clients on founder.
- Cultural values that discourage succession planning.

Overcoming the forces against succession planning requires the commitment of the family and employees of the business.

Succession occurs in four phases: initiation, selection, education and transition. A discussion of each phase follows.

### *Initiation*

The initiation phase is that period of time when the children learn about the family business. It occurs from the time the children are born. A child can receive either a positive or a negative impression of the family business. If parents bring home the negative aspects of the business, complaining about it and about employees and relatives, the children will view the business in a very poor light. Other ways to destroy children's interest in the business is to be secretive about it or to convey an unwelcome or a hands-off attitude. There are families in which children are welcome to join the family business, but no one has told them so.

Owners are often cautious about systematically conditioning their children to enter the family business, an attitude that stems primarily from their awareness of individual differences and their belief that their children should be free to select a career path. If you do want your children to enter the business, or at least have that as a career alternative, there are some steps you can take to initiate them into the firm. The first step in motivating your children is to be certain that is what you want. Your lack of conviction about their involvement will be communicated to them. This may be interpreted as doubt about their ability, about the viability of the business or about the potential of the parent-child relationship to survive the strain of succession. Any of these situations can cause your child to lose interest in the business.

Assuming your children know that you want them to enter the business, you should talk with them often and openly about it. Be realistic, but stress the positive aspects. Your business provides you with many positive experiences to share with your children. Your children should learn what values the business represents, what the business culture represents and where the business is headed.

### **Selection**

Selection is the process of choosing who will be the firm's leader in the next generation. Of the entire transition process, this can be the most difficult step, especially if you must choose among a number of children. Selecting a successor may be viewed by siblings as favoring one child over the others, a perception that can be disastrous to family well-being and sibling harmony. Owners select successors on the basis of age, sex, qualifications or performance. Because of the potential for emotional upheaval, some owners avoid the issue entirely, adopting an attitude of "Let them figure it out when I'm gone."

Nevertheless, there are several solutions to this dilemma. Assuming you have more than one child who is or can become qualified for the position of president, you can select your successor based on age. For example, the oldest child becomes the successor. Unfortunately, the oldest may not be the best qualified. Placing age or sex restrictions on succession is not a good idea.

Alternatively, you could have a "horse race." Let the candidates fight it out, and the "best person" wins. While this is the style in some major corporations, it is not the best option for all family businesses.

Family business owners may want to take advantage of a successor selection model developed for corporate executive succession. In this model, family members, using the strategic business plan, develop specific

company objectives and goals for the future president or chief executive officer. The job description includes the requirements for the position—such as skills, experience and possibly personality attributes. For example, if a firm plans to pursue growth in the next five years, the potential successor would be required to have a thorough understanding of business valuations and financial statements, the ability to negotiate and a good relationship with local financial institutions.

Designing such job descriptions provides a number of benefits. First, it removes the emotional aspect from successor selection. If necessary, the successor can acquire any special training the job description outlines. Second, it provides the business with a set of future goals and objectives that have been developed by the whole family. Finally, the founder may feel more comfortable knowing objectives are in place that will ensure a growing, healthy business.

If you have an outside board of directors, you may want to solicit their input regarding successor selection. The form in Appendix D will help assess the potential successors in your company.

### **Education**

Training or educating the successor in the firm is a delicate process. Many times a parent finds it difficult to train a child to be successor. If so, an alternative trainer may be found within the firm. A successful trainer will be logical, committed to the task, credible and action oriented. These attributes, when tied into a program that is mission aligned, results oriented, reality-driven, learner centered and risk sensitive, will produce a well-trained beneficiary. All of this, of course, is easier stated than accomplished.

A training variant of the management by objectives (MBO) concept is the training by objectives (TBO) concept. This concept can be an effective method for providing both the training for and the evaluation of successors. In the TBO process, both the trainer (you or a nonfamily manager) and the trainee (potential successor) work together to define what the trainee will do, the time period for action and the evaluation process to be used. This system allows the successor to be placed in a useful, responsible position with well-delineated objectives. It also provides for steps of increased responsibility as goals are met and new, more rigorous goals are established. It is important that the successor enter the firm in a well-defined position. Instead of entering the company as "assistant to the president," which requires that he or she follow the president around all day, the successor (or any other child) should enter with a specific job description. In a small business this is very difficult because everyone

is usually responsible for all tasks. Nevertheless, the successor cannot be evaluated effectively if he or she is not given responsibility and authority for certain tasks.

Your business will enable you to determine which criteria are necessary for good training. Usually, an owner wants to assess a successor in the following areas:

- Decision-making process.
- Leadership abilities.
- Risk orientation.
- Interpersonal skills.
- Temperament under stress.

An excellent way to assess these skills is to let the successor give his or her insight on a current problem or situation. This is not a test and should not be confrontational. Instead, solicit advice and try to determine the thinking process that is generating your successor's suggestions. For example, you may be faced with a pricing decision. Give the successor all the information needed to determine whether or not to raise prices, then sit back and listen. Ask questions when appropriate—these should be "Why?" and "What if?" After the successor is finished, say "I was considering. . . ." This way each of you can learn how the other thinks and makes decisions.

It is possible that your leadership style differs from that of your successor. Your employees are used to your style. If your successor's style is very autocratic and uncaring, your company is going to experience problems.

Potential successors should be introduced into your outside network (e.g., customers, bankers and business associates), something many managers neglect. This will give everyone time to get to know your successor and allow the successor to work with business associates and bankers, and to get acquainted with customers.

### **Transition**

The actual transfer of control to the successor occurs when you retire. Research indicates that transitions are smoothest when

- They are timely.
- They are final and do not include the entrepreneur's participation in daily activities.
- The entrepreneur is publicly committed to an orderly succession plan.
- The entrepreneur has articulated and supervised the formulation of company principles regarding management accountability, policies, objectives and strategies.

The transition can be effected gradually by relinquishing more and more responsibility to the successor. One expert advises the entrepreneur to take a number of planned absences before actually relinquishing control. Let the successor see what it is like to manage the business alone. Also, this allows you to see that the business is not going to fall apart without you.

Once you announce your retirement date, do not rescind it. There is no such thing as semiretirement. By the time your children are in their 40s, they expect leadership roles in the firm. If you refuse to let go, they may leave.

### **Letting Go**

There are many reasons why entrepreneurs cannot let go of the family business. Primary among these are financial ones. As a business owner, you may be used to a large salary and benefits, such as a car or insurance. After working hard in the business most of your life, you want your retirement years to be comfortable, not filled with financial anxieties. There are several ways to ensure your financial security after retirement. Business owners usually consider either taking what they need from the company after they retire or arranging a buy-out that will give them the needed liquidity without placing an undue financial burden on the company. If you don't sell the company and your financial security is contingent on its daily operations, you will be less likely to retire completely. Your successor needs full control, and you probably won't let that happen. Also, the company may not be able to support you and the successor and still pursue the strategy you have set for it. Finally, you may not be able to meet your financial goals from income generated by the company.

To avoid these problems, consult with a financial planner or an attorney to determine the method of transfer that is best for you. There are tax consequences to the outright sale of the business to your children. Also, an outright sale may burden the company with too much debt. Other alternatives include an installment sale or private annuity, or funding a buy-sell with insurance proceeds. To provide effectively for your retirement, seek professional assistance in this area.

There are other reasons why the entrepreneur doesn't want to let go. One of the primary reasons is the fear of retirement. To understand this fear, it is necessary to appreciate the relationship between work, the meaning of life and social evaluation. For many founders, work and the business are synonymous with a meaningful life. The intense involvement the entrepreneur has with the business increases the importance of the job and his or her identity. Removal from work is like losing a part of oneself. Work is important to the entrepreneur because it provides

- Economic returns.
- Opportunities to contribute to society.
- Status and self-respect.
- Social interaction.
- Personal identity.
- Structured time.
- Escape from loneliness and isolation.
- Personal achievement.

That's a lot to ask someone to give up. Especially important is the loss of status and social power. The leader of a firm wields a great deal of influence and enjoys public impact and public exposure. Retirement means giving up this power. Because this loss is unpleasant, it is not uncommon for a founder to give a successor the responsibility for running a firm and still try to retain power and privileges from a position on the board of directors.

The entrepreneur who successfully lets go has (1) a sound financial plan for retirement, (2) activities outside the business that can provide social contact and power, (3) confidence in the successor and (4) a willingness to listen to outside advisors.

### **Board of Directors**

Most small businesses do not have a board of directors, but a board can be invaluable during the succession process. A board can help management determine objectives and strategies, provide specialized expertise and even arbitrate feuds among family members.

The board is usually composed of both insiders and outsiders. Although family businesses usually are operated in a very private manner, there are benefits to making outsiders board members. They come with different backgrounds and perspectives, and provide checks and balances. Outside directors don't work out well if they lack knowledge about the firm and its environment, or if they are uncommitted to board responsibilities.

If you decide to develop a board, you should be totally committed to the process. There are difficulties associated with boards (time and money) and the entrepreneur must be willing to make the board a viable entity.

The first step would be to establish goals and objectives for the board. You should set these objectives before you recruit or make a commitment to any members. Boards can expand your network, provide input into the

succession process, judge the successor's progress or help determine a transition date. But boards should not get overly involved in operational or day-to-day issues.

The second step is recruiting. A board should have five to seven members, including three or four outsiders. Select them carefully. You can find them in civic and charitable organizations, among acquaintances and at local universities. You should know and have a good rapport with prospective members, and you should determine their ability to provide concrete advice and direction for the business. The following are a few good questions to ask:

- What is their background?
- How are they thought of in the community?
- What do your present directors think of them?

Make sure they have the qualifications to help realize the goals and objectives you have set. The remainder of the board is composed of top insiders. Your potential successor may be invited to attend the meetings, or you may choose to make him or her a member of the board.

If you decide to develop a board, or if you feel you need to know more, you will find *Outside Directors in the Family Owned Business* to be an excellent reference on the topic. It is listed in the reference section.

### **Making Succession Work**

To make succession work, you must communicate. This is the key ingredient. Use the family retreat as well as family meetings. Family meetings can educate the family in discussions about the nature of the firm, the kinds of leadership skills needed, entry and exit conditions, decision-making policies and conflict resolution procedures. Casual conversations about these issues can contribute to your formal planning later on.

Family meetings do not have to be formal affairs, but they should occur regularly and have an agenda. Parents don't have to lead the meeting; have the offspring organize and conduct a portion of the meeting. Use the meetings to defuse any potential time bombs.

Anticipate problems. Will there be any problems with nonfamily members? If so, which ones? How will they be a problem, and what can you do (short of firing them) to handle it?

Sibling rivalry is another problem to consider. Does it exist? If so, how will you resolve it? It may not be a problem until the successor is named. Develop a code of conduct for sibling relations. This code will outline how siblings must act toward each other (i.e., in a way conducive to a healthy business), including how to work

together, how to play together and how to keep spouses informed about what's going on. Anticipate problems that may arise and meet them head on.

## Summary

Succession is a process that may extend from three to six years or longer depending on your age and on your successor's age. It occurs in phases. Over a period of time, you initiate or educate your children to the family business. After determining a successor, you develop a plan to transfer leadership in the family business. The decision to announce who the successor is and when the transition will occur depends on the family.

## ESTATE PLANNING

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The last plan to consider is your estate plan. In the family business, the bulk of your assets are usually tied up in the business. You need an attorney who understands family business and the laws concerning transferring business assets across generations. While the following information is not a substitute for advice from legal counsel, it may help you in planning your estate.

The 1990 income tax law revived the recapitalization technique known as "estate freeze," which had been eliminated. This technique allows the owners of a business to reduce their estate taxes by freezing the value of the business at a particular point in time. Estate taxes are reduced because the majority of the stock of the business will not appreciate over time.

The owners do this by creating preferred stock that enables them to retain operating control of the business while transferring common stock to their children. Unlike common stock, preferred stock will not appreciate over time. However, when preferred stock is transferred to the children, they will pay estate taxes in the form of gift taxes. It is highly recommended that you consult legal counsel concerning this matter because tax laws are constantly changing.

### Transfer Tax Deferral Techniques

This first set of techniques includes the will, living trust, marital deduction trust and installment payment.

The *last will and testament* is a legal declaration of your desires or wishes regarding the disposition of your probate estate. It is the basic element of most estate plans.

There are benefits to making an early announcement, including (1) reassuring employees, suppliers and customers, (2) allowing siblings time to adjust to the decision and to make alternative career decisions, if necessary, and (3) enabling the entrepreneur to plan for retirement.

The fundamental goal should be to pass the family business successfully to the next generation. To do this you must feel financially secure, secure with the company's future goals and plans and secure with your successor.

If you have not prepared your own will, your state of residence has prepared one for you through its laws and regulations.

The *living trust* is a completely changeable agreement between its creator (donor) and its property manager (trustee) established for the benefit of a recipient (beneficiary). It is created while the donor is alive to hold assets for the donor's use until death and for use in transferring property outside of the donor's will (as part of the donor's nonprobate estate) upon the donor's death. It is particularly useful in managing the donor's property during a long term disability.

The *marital deduction trust* is created in your will or in your living trust for the benefit of your spouse after your death. The minimum benefit your surviving spouse can receive is the mandatory distribution of income from the trust property. Your spouse's rights to the trust principal while you are alive can be limited by you as stated in the trust agreement. Property placed in a qualified marital deduction trust is not subject to federal estate tax at your death. Instead, any tax is assessed when your spouse dies. This type of marital deduction trust is called a qualified terminable interest property trust (QTIP Trust). The disposition of the trust property, if any, remaining at your spouse's death is determined by you under the terms of the trust agreement, not by your spouse's will.

A fourth transfer tax deferral tool is the *installment payment* of the federal estate tax attributable to the value of a family business. Internal Revenue Code Section 6166 allows a 14-year payout of the estate tax. To qualify, the family business must be an active trade or business, and your interest in the business must have a value equal to at least 35 percent of your estate. Qualification of the

deferred payout allows you to pay no federal estate tax on the value of the family business for five years. The federal estate tax, with annual interest, is paid in equal annual payments over a ten-year period beginning in the fifth year. However, a sale by your heirs of 50 percent or more of your interest in the family business during the payout period will result in accelerating the estate tax payment.

### Transfer Tax Exclusion Techniques

A second set of tools available to the estate planner are transfer tax exclusion techniques. These include the unified credit/exemption equivalent trust, the dynastic trust, the annual exclusion gift, unified credit/exemption equivalent gift and the statutory grantor retained interest trust.

The *unified credit/exemption equivalent trust* is created in your will or living trust for the benefit of whomever you desire. It is funded with the maximum amount of property you can leave to beneficiaries other than your spouse without the application of the federal estate tax (generally \$600,000). While you are free to designate any trustee and beneficiary you desire to provide for restrictive or expansive trust terms, normally your surviving spouse or children are the beneficiaries.

The *dynastic trust* is created in your will or in a living trust. It is funded with the maximum amount of property you can leave to grandchildren or other third generation beneficiaries without the application of the federal generation-skipping transfer tax (generally one million dollars).

The *annual exclusion gift* consists of gifts of cash or other property of \$10,000 or less per recipient per year. These are free of federal gift taxation. Such gifts, as well as their appreciation in value and future income from them, are also excluded from federal estate and generation-skipping transfer taxation.

The *unified credit/exemption equivalent gift* is a gift of a future interest in property or of a personal interest in excess of the annual exclusion gift amount. This gift may be made in the amount of \$600,000 during your lifetime without incurring federal gift taxation and will exclude postgift appreciation and income of the property from your estate for purposes of federal transfer taxation. This tool is integrated with the unified credit/exemption gift. This means the unified credit's exclusion of \$600,000 in property value is allowed only once. You may, however, choose to take it while you are living or at your death.

The *statutory grantor retained interest trust* is a trust created while you are alive. It provides for retaining an income interest in the property transferred to the trust for a ten-year term. It also provides a transfer, by you, of a remainder of the interest in the trust property to a third party at the end of the term. The value of your gift for federal gift tax purposes is the value of the remaining interest as determined by an IRS table. If you survive the trust term, the entire value of the trust property (including any appreciation in the value of the property) is excluded from your estate. If you die during the trust term, the entire trust property, at its value on the date of your death, is subject to federal estate taxation. You, however, receive credit for any gift tax paid or unified credit used in creation of the trust. But you may not be the trustee of this trust.

Again, seek competent legal help when you begin planning your estate. There are some aspects of estate planning that you should consider. Many times the bulk of the business owner's estate is the business assets. If you leave these assets to your successor, other siblings may be left out. If you divide them equally among siblings, you deny control to your successor. Children need to be treated fairly; therefore, it is important that you consider carefully all aspects of estate planning.

## SUMMARY

Transferring the family business requires the family to make a determined effort to do the following:

- Communicate.
- Create a business strategic plan, including
  - Business mission.
  - Business goals.
  - Strategy to achieve goals.
- Create a family strategic plan, including a
  - Unified vision of the family's role in the business.
  - Code of conduct for family members.
  - Joint operating policies that serve the family and business.
  - Family creed.



- Prepare a Financial Plan for Retirement.
- Prepare an Estate Plan.
- Prepare a Succession Plan, including
  - Arranging for successor training.
  - Setting a retirement date.
  - Championing your successor.

There are many organizations, books and magazines that can help you plan and manage a successful family business. Refer to Appendix E: Information Resources. Gather as much information and read as many references as possible before you devise a plan for managing and transferring the family business. You will find that following the guidelines discussed in this publication will make the process easier and more successful.

## REFERENCES

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Benson, B., E.T. Crego, and R.H. Drucker. *Your Family Business*. Homewood, IL: Dow Jones-Irwin, 1990.

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Ward, J.L. *Keeping the Family Business Healthy*. San Francisco: Jossey-Bass Publishers, 1988.



## APPENDIX A: FAMILY BUSINESS ASSESSMENT INVENTORY

Section I	YES	NO
<i>Business issues</i>		
1. Have goals for sales and profits been set?	_____	_____
2. Do we have a business plan?	_____	_____
3. Do we have a strategic plan?	_____	_____
4. Is the business in good financial standing?	_____	_____
5. Do we have a compensation system?	_____	_____
6. Do we have a performance appraisal system?	_____	_____
7. Do we have a board of directors?	_____	_____
8. Can we attract and retain nonfamily managers?	_____	_____
9. Is the business in a highly competitive industry?	_____	_____
10. Are we experiencing an increase in sales?	_____	_____
<i>Family business issues</i>		
1. Do family members know they are welcome to join the firm?	_____	_____
2. Do we have policies for entry into and exit from the firm?	_____	_____
3. Is a system in place to train and develop the successor?	_____	_____
4. Do we have a succession plan?	_____	_____
5. Can family members in the firm effectively communicate?	_____	_____
6. Do we have a system to resolve conflict among family members?	_____	_____
7. Are women welcomed in the business?	_____	_____
8. Is there a minimum amount of sibling rivalry in the firm?	_____	_____
9. Is there a system in place for choosing a successor?	_____	_____
10. Does the family agree on goals for the business?	_____	_____

If you answered no to any item, action should be outlined and implemented to address and set policies for that item.

### Section II

The following items need to be discussed in the family business:

- Leadership succession.
- Ownership transfer.
- Communication policies.
- Compensation policies.
- Rights and responsibilities of nonfamily employees.
- Rights and responsibilities of in-laws.
- Creating change.

- Development of a management team.
- Long-term planning for the business.
- Obtaining financing.
- Financial equity among children.
- Resolving conflict.
- Hiring and firing practices.
- Sibling rivalry.
- Organizational relationships.
- Working with advisers.

This list should be distributed to every family member. Responses should be compared and issues of concern to family members identified. Unresolved issues should be discussed and policies established to resolve them.

## APPENDIX B: STRATEGIC PLAN CHECKLIST

	YES	NO
1. Have I listed the emerging opportunities in my industry?	_____	_____
2. Have I listed the environmental threats to my firm?	_____	_____
3. Have I listed the internal strengths of my firm?	_____	_____
4. Have I listed the internal weaknesses of my firm?	_____	_____
5. Have my family and I listed our personal goals and objectives?	_____	_____
6. Do I have a mission statement?	_____	_____
7. Have I listed goals (objectives) for the firm?	_____	_____
8. Are the objectives for my firm in line with my family's personal goals?	_____	_____
9. Are the objectives for my firm in line with the analysis of my firm's strengths and weaknesses?	_____	_____
10. Have I written a strategy to meet my objectives?	_____	_____
11. Are my actions		
—manageable (one year or less)?	_____	_____
—accountable (someone is responsible)?	_____	_____
—reasonable?	_____	_____



## APPENDIX C: PRE-RETREAT PLANNING

Determine which questions would be most beneficial to address at your retreat. Have everyone answer these.

### *Personal Questions*

1. Do you have a desire to be the successor in the family business?
2. What are your reasons for wanting to be the successor?
3. Have you signed a letter of commitment?
4. Do you intend to work outside the family business?
5. Do you have the necessary education to handle the job?
6. Are your values comparable to the founder's values?
7. What strengths do you have that can benefit the organization?
8. Do you have a vision for the company?
9. Are you willing to make sacrifices (such as your family time) for the business?
10. Is your choice to become successor your own, or is it expected by the family?

### *Questions Dealing with the Family*

1. What are the reasons for perpetuating the family business?
2. Are you aware that the odds are not in favor of the survival of the business?
3. What is the history of the family business?
4. How does the family get along?
5. Is anyone qualified to be the successor?
6. Who will choose the successor?
7. How will the successor be chosen?
8. At what age will potential successors be allowed to work in the family business?
9. Is there a minimum education level required to become the successor?

10. Will there be a position in the family business for all interested relatives?
11. Are there any special conditions for entering the family business?
12. Who will determine salaries?
13. Will salaries be paid evenly across the board or by performance?
14. Will a mentor be assigned?
15. Will the successor be accepted by the family?
16. Is anyone in the family eligible to become the successor?
17. How will conflict among relatives be resolved?
18. Will the successor start in an entry-level or management position?
19. At approximately what age will the successor take control?
20. Will a spouse be allowed to work in the family business?
21. How long will the potential successor remain in control?
22. Is there a procedure for filing grievances in the business?
23. Is there a code of conduct?
24. Will all potential successors work at the headquarters or at different divisions?
25. Are the successor's suggestions taken seriously?

### *Questions Relating to the Business*

1. In what stage of the industry life cycle is the family business?
2. What is the company's mission statement?
3. Can the business support another executive?
4. What are the company's strengths and weaknesses?
5. Who are the firm's competitors?

6. Are there any barriers to entry?
7. What are the competitors' strengths and weaknesses?
8. What is the business's current market share?
9. Has the founder told employees the business will stay in the family?
10. Do employees hear news directly or through the grapevine?
11. How does the family business compare with other companies in the same industry?
12. Is there a manager in place capable of running the business if something should happen to the founder and the successor is not ready?
13. Will current employees stay when the power changes hands?
14. Are the company's goals shared by the employees?
15. Is the family business ahead or behind technologically?
16. Does the interest of the family or at the business come first?
17. Is the family willing to sacrifice today to prosper later?
18. Will the employees accept the successor?
19. Is the timing right to announce the successor?
20. Is there fresh talent in senior level positions?
21. Is there an established budget?
22. Is reinvesting in the family business a priority?



APPENDIX D: ASSESSMENT OF CANDIDATES

Instructions: List below all of the potential successors to you as principal owner. For each quality, rate the candidate on a scale of one to five, with five very high and one very low.

Name	Related education	Relevant experience	Commitment to family and firm	Management style	Communication ability	Financial stewardship for the family	Creativity	Guts and ambition	Alignment with your values	Total
Total										

Meaning of totals: The total for each candidate is your assessment of how capable he or she would be as a successor. The total column across the bottom indicates the qualities in good supply in your group and those that may be lacking.



### **U.S. Small Business Administration (SBA)**

The SBA offers an extensive selection of information on most business management topics, from how to start a business to exporting your products.

This information is listed in *The Small Business Directory*. For a free copy contact your nearest SBA Office.

SBA has offices throughout the country. Consult the U.S. Government section in your telephone directory for the office nearest you. SBA offers a number of programs and services, including training and educational programs, counseling services, financial programs and contract assistance. Ask about

- **Service Corps of Retired Executives (SCORE)**, a national organization sponsored by SBA of over 13,000 volunteer business executives who provide free counseling, workshops and seminars to prospective and existing small business people.
- **Small Business Development Centers (SBDCs)**, sponsored by the SBA in partnership with state and local governments, the educational community and the private sector. They provide assistance, counseling and training to prospective and existing business people.
- **Small Business Institutes (SBIs)**, organized through SBA on more than 500 college campuses nationwide. The institutes provide counseling by students and faculty to small business clients.

For more information about SBA business development programs and services call the SBA Small Business Answer Desk at 1-800-U-ASK-SBA (827-5722).

### **Other U.S. Government Resources**

Many publications on business management and other related topics are available from the Government Printing Office (GPO). GPO bookstores are located in 24 major cities and are listed in the Yellow Pages under the "bookstore" heading. You can request a *Subject Bibliography* by writing to **Government Printing Office, Superintendent of Documents, Washington, DC 20402-9328**.

Many federal agencies offer publications of interest to small businesses. There is a nominal fee for some, but most are free. Below is a selected list of government agencies that provide publications and other services targeted to small businesses. To get their publications, contact the regional offices listed in the telephone directory or write to the addresses below:

#### **Consumer Information Center (CIC)**

P.O. Box 100  
Pueblo, CO 81002

The CIC offers a consumer information catalog of federal publications.

#### **Consumer Product Safety Commission (CPSC)**

Publications Request  
Washington, DC 20207

The CPSC offers guidelines for product safety requirements.

#### **U.S. Department of Agriculture (USDA)**

12th Street and Independence Avenue, SW  
Washington, DC 20250

The USDA offers publications on selling to the USDA. Publications and programs on entrepreneurship are also available through county extension offices nationwide.

#### **U.S. Department of Commerce (DOC)**

##### **Office of Business Liaison**

14th Street and Constitution Avenue, NW  
Room 5898C

Washington, DC 20230

DOC's Business Assistance Center provides listings of business opportunities available in the federal government. This service also will refer businesses to different programs and services in the DOC and other federal agencies.

#### **U.S. Department of Health and Human Services (HHS)**

##### **Public Health Service**

##### **Alcohol, Drug Abuse and Mental Health**

##### **Administration**

5600 Fishers Lane  
Rockville, MD 20857

Drug Free Workplace Helpline: 1-800-843-4971. Provides information on Employee Assistance Programs.

National Institute for Drug Abuse Hotline:

1-800-662-4357. Provides information on preventing substance abuse in the workplace.

The National Clearinghouse for Alcohol and Drug Information: 1-800-729-6686 toll-free. Provides pamphlets and resource materials on substance abuse.

**U.S. Department of Labor (DOL)**  
**Employment Standards Administration**  
200 Constitution Avenue, NW  
Washington, DC 20210  
The DOL offers publications on compliance with labor laws.

**U.S. Department of Treasury**  
**Internal Revenue Service (IRS)**  
P.O. Box 25866  
Richmond, VA 23260  
1-800-424-3676  
The IRS offers information on tax requirements for small businesses.

**U.S. Environmental Protection Agency (EPA)**  
**Small Business Ombudsman**  
401 M Street, SW (A-149C)  
Washington, DC 20460  
1-800-368-5888 except DC and VA  
703-557-1938 in DC and VA  
The EPA offers more than 100 publications designed to help small businesses understand how they can comply with EPA regulations.

**U.S. Food and Drug Administration (FDA)**  
**FDA Center for Food Safety and Applied Nutrition**  
200 Charles Street, SW  
Washington, DC 20402  
The FDA offers information on packaging and labeling requirements for food and food-related products.

### ***For More Information***

A librarian can help you locate the specific information you need in reference books. Most libraries have a variety of directories, indexes and encyclopedias that cover many business topics. They also have other resources, such as

- **Trade association information**  
Ask the librarian to show you a directory of trade associations. Associations provide a valuable network of resources to their members through publications and services such as newsletters, conferences and seminars.
- **Books**  
Many guidebooks, textbooks and manuals on small business are published annually. To find the names of books not in your local library check *Books In Print*, a directory of books currently available from publishers.
- **Magazine and newspaper articles**  
Business and professional magazines provide information that is more current than that found in books and textbooks. There are a number of indexes to help you find specific articles in periodicals.

In addition to books and magazines, many libraries offer free workshops, lend skill-building tapes and have catalogues and brochures describing continuing education opportunities.

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